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Supreme Court of the United States

October Term, 1997

MERRILL LYNCH, PIERCE, FENNER & SMITH, INCORPORATED, PAINE WEBBER INCORPORATED, AND DEAN WITTER REYNOLDS INC.,

Petitioners,

vs.

JEFFREY PHILLIP KRAVITZ, GLORIA BINDER, AND BRUCE ZAKHEIM IRA FBO BRUCE ZAKHEIM,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit

BRIEF OF THE NATIONAL VENTURE CAPITAL ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

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INTERESTS OF THE *AMICUS CURIAE*[1]

The National Venture Capital Association is composed of more than 280 professional venture capital firms which, in the aggregate, invest more than 80 percent of all professional venture capital dollars yearly in the nation's emerging growth companies. In 1997, more than $12 billion in venture capital was invested in more than 2,000 companies. The vast majority of these companies are in the high technology industries, including software, communications, healthcare services, electronics, medical devices and biotechnology. Most of the nation's premier companies in these disciplines have, at one point in their operation, obtained venture capital funding. The investment dollars for venture capital financing come largely from limited partners who represent pension funds, colleges and endowments, corporations, banks, insurance companies and high net worth individuals.

Venture capital investing is focused on young companies which are predominantly dedicated to research and development. A common growth path for these companies is to issue shares in an Initial Public Offering. Those shares are frequently traded on the NASDAQ Stock Market, the market in which the practices giving rise to the instant litigation arose.

Venture capitalists frequently become members of the Boards of Directors of the companies in which they invest, taking on fiduciary obligations to the companies and their shareholders. By adopting an overly broad

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[1] The parties have consented to the filing of this brief. Copies of the letters of consent have been lodged with the Clerk of the Court. This brief was not authored in whole or in part by counsel for a party, and no person or entity, other than *amicus curiae*, its members, and their counsel made a monetary contribution to the preparation and submission of this brief.

interpretation of the implied private right of action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, the Third Circuit decision in this case threatens to exacerbate the problem of "vexatious litigation" that already plagues companies in high technology industries. *Amicus* has a strong interest in reversal of the Third Circuit's ruling that the alleged breach of the fiduciary duty of "best execution," committed by following practices that were publicly known, could give rise to liability under Section 10(b) and Rule 10b-5.

INTRODUCTION: THE PRACTICE AT ISSUE AND THE RULINGS BELOW

Petitioners are broker-dealers in the NASDAQ Stock Market. The NASDAQ Stock Market is "the major electronic market for 'over-the-counter' securities." Pet. App. 2a. It is, by several measures, the largest equities market in the world.[2]

Broker-dealers are subject to a duty of "best execution" which requires them "to execute the plaintiffs' trades at the best *reasonably* available price." Pet. App. 7a (emphasis supplied). The duty of best execution is a fiduciary obligation, Pet. App. 47a, that is "not codified in any SEC rule."[3] It "predates the federal securities laws, [and] has its roots in the common law agency obligations

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[2] *See, e.g., The NASDAQ Stock Market 1997 Fact Book & Company Directory* 1 (The NASDAQ market "has more listed companies than any other market in the world" and trades "more than half of all equity shares traded in the United States.").

[3] Division of Market Regulation, United States Securities and Exchange Commission, *Market 2000: An Examination of Current Equity Market Developments*, 1994 SEC LEXIS 136, at V-2 (Jan. 1994) ("the Commission has not promulgated a separate best execution rule").

of undivided loyalty and reasonable care that an agent owes his principal." Pet. App. 6a.

Price is not, however, the sole determinant of best execution. Customers also want speed, both for its own sake and because taking the time to search among a set of alternative market mechanisms may lead to a worse price, particularly in a rapidly moving market. Therefore, when "determining how to execute a client's order a broker-dealer must take into account order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market." Pet. App. 7a n.2. The fiduciary duty of best execution is thus fluid and as, "the SEC has recognized on a number of occasions, the scope of the duty of best execution has evolved over time with changes in technology and transformation of the structure of financial markets." Pet. App. 8a.

During the time period at issue, the NASDAQ Stock Market operated through an electronic quotation system which "tied together the numerous market makers for all over-the-counter securities available on NASDAQ." Pet. App. 3a. The market's central computer continually searched the bids and offers submitted into the system to identify the "highest bid price and lowest ask price currently available." Pet. App. 3a. These prices are called the National Best Bid or Offer, or "NBBO."

It was common practice among broker-dealers during the alleged class period to rely on execution at NBBO as satisfying the duty of best execution. The industry's widespread reliance on this practice was known to the Securities and Exchange Commission and to the industry's self-regulatory organization, the National Association of Securities Dealers ("NASD"). Pet. App. 26a. The

practice was also fully disclosed in public documents that were available to all members of the putative class prior to the beginning of the alleged class period.[4] These documents explain the industry's position that "best execution obligations for small, retail orders are satisfied when those orders are executed at the best displayed bid or offer [*i.e.*, the NBBO] at the time the trade is executed."[5] Press reports also clearly described the industry's position that "small orders executed at the best bid or offer are receiving best execution . . . "[6]

Nothing could be more clear. The allegedly fraudulent practice at the heart of this case was public information. "It [was] no secret." Pet. App. 74a.

In their putative class action, plaintiff-respondents allege that the practice of relying on the NBBO to satisfy a broker-dealer's best execution obligation constituted fraud, practiced with an intent to deceive, in violation of Section 10(b) and Rule 10b-5 thereunder. Plaintiff-respondents assert that prices superior to the NBBO were available from other sources, and that broker-dealers violated their best execution obligations by not searching outside the NBBO for those allegedly superior prices.

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[4] *Inducements for Order Flow: A Report to the Board of Governors, National Association of Securities Dealers Inc.* 3 (July 1991).

[5] *Id.* In the Report's view, reliance on the NBBO constituted effective compliance with the best execution obligation because "customers benefit from receiving low-cost, fast, and assured executions at the quoted best bid or offer, and those benefits may equal or exceed benefits obtained through the potential for receiving an execution inside the quotation spread." *Id.*

[6] *NASD Panel: Order Flow Cash Payments Need No Special Rules*, Dow Jones News Service, July 23, 1991, available in WESTLAW, Allnewsplus database.

The district court converted Petitioners' motion to dismiss to one for summary judgment and granted it. The court observed that " 'best execution' does not necessarily mean 'best price,' " Pet. App. 69a, and that "[i]t is undisputed that defendants' reliance on NBBO prices when executing small orders is widely, if not almost universally, followed with respect to OTC securities. That this is the practice is fully known in the industry. It is no secret." Pet. App. 74a. The Court further explained that "a jury could not reasonably find that there was an intent to deceive or an 'extreme departure from the standards of ordinary care' sufficient to constitute the requisite scienter for a claim of fraud." Pet. App. 73a.

On appeal, a panel of the Third Circuit affirmed. The court expressly held that "where defendants are under no affirmative legal duty to disclose their order execution practices and those practices are widely followed within the securities industry, as a matter of law there is no scienter when defendants fail to disclose those practices." Pet. App. 25a. The court explained that "[t]o prevail on summary judgment, one need not show that *every* dealer executes trades at the NBBO price, but merely that enough dealers do so that the duty to supplement the NBBO price is *ambiguous*, and scienter is negated." Pet. App. 26a (emphasis in original). Moreover, the fact that the SEC decided to address the relationship between NBBO practices and best execution obligations through a complex set of order execution regulations which came into effect while the appeal was pending, "indicates strongly, if not conclusively that, the 'duty' . . . to look beyond the NBBO for pricing information was ambiguous, indeed speculative, during the class period." Pet. App. 27a.

On rehearing *en banc*, the Third Circuit reversed and remanded for trial. The *en banc* court described the

alleged misrepresentation as a violation of "an implied representation made by the defendants . . . that they intended to *maximize* the plaintiffs' economic gain in the transaction." Pet. App. 12a (emphasis supplied). The *en banc* court reasoned, through a self-described "chain of inferences," Pet. App. 13a, that if a firm accepted a market order then it impliedly represented that it would "obtain a price more advantageous to the plaintiffs than the NBBO when one was readily available." Pet. App. 12a. The *en banc* court concluded that the Petitioners "knew that they intended to execute the plaintiffs' orders at NBBO price even if better prices were reasonably available," and that a "reasonable trier of fact could thus find scienter with respect to a material misrepresentation," Pet. App. 16a, where scienter is defined as conduct that is "at least reckless, if not intentional." Pet. App. 13a.

SUMMARY OF ARGUMENT

The Petition for a Writ of Certiori should be granted for two distinct reasons.

First, the *en banc* decision below raises profound questions regarding the scope of conduct that is actionable as fraud under Section 10(b) of the Securities and Exchange Act of 1934, and Rule 10b-5, as well as the definition of "scienter" thereunder. These questions have significant implications for the administration of justice and for the operation of the nation's securities markets. Hundreds of class action and individual securities fraud lawsuits alleging billions of dollars of damages are today pending in federal court. The lion's share of these cases raise claims under Section 10(b). If followed, the Third Circuit's ruling could massively expand the scope of liability in these pending civil actions. The decision below also has profound implications for the continued operation of the Securities and Exchange Commission's

enforcement program, and for the conduct of business in the nation's increasingly complex and growing securities markets.

Second, the decision below is in plain error. Contrary to this Court's ruling in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), the Third Circuit holds that a practice that allegedly constitutes a breach of a fiduciary duty, but that is a matter of public record and is fully known to the SEC and to self-regulatory organizations, could constitute actionable fraud under Section 10(b). If upheld, this decision provides a roadmap for the federalization and securitization of every breach of fiduciary duty claim in connection with every securities transaction. The Third Circuit compounds this error by concluding that publicly disclosed practices that are widely followed in an industry and well known to industry regulators could be conducted with "scienter" – a state of mind "embracing intent to deceive." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976); *see also Herman & McLean v. Huddleston*, 459 U.S. 375, 382 (1983). It thereby materially expands the definition of scienter far beyond the language of the statute and beyond this Court's established precedent.

Indeed, if the Third Circuit's interpretations of *Santa Fe*, *Hochfelder*, or *Huddleston* are allowed to stand, the courthouse doors will be thrown open to litigation challenging conduct that has not heretofore been considered fraudulent under Section 10(b). The result would be a proliferation of "vexatious litigation" under an implied private right of action which Congress never expressly contemplated and which this Court has consistently sought to contain. *See, e.g., Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *Central Bank v. First Interstate Bank*, 511 U.S. 164, 172-73 (1994).

ARGUMENT

I. THE THIRD CIRCUIT'S DECISION HAS PROFOUND IMPLICATIONS FOR HUNDREDS OF CIVIL ACTIONS PENDING IN THE FEDERAL COURTS, FOR THE CONTINUED OPERATION OF THE SEC'S ENFORCEMENT PROGRAM, AND FOR THE EVOLUTION OF THE NATION'S SECURITIES MARKETS.

Chief Justice Rehnquist describes the civil liability arising under the implied private right of action found in Section 10(b) of the Securities and Exchange act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5, thereunder, 17 C.F.R. § 240.10b-5 as "a judicial oak which has grown from little more than a legislative acorn." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975). The span of that judicial oak is today truly breathtaking.

Since January 1, 1996, at least 366 issuers have been sued in private federal class action securities fraud proceedings, and the vast majority of these cases are still pending in the federal courts.[7] Between January 1991 and June 1996, approximately $3.9 billion was paid out in settlement awards in federal class action securities fraud litigation.[8] The large majority of these cases, pending and

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[7] *See Stanford Law School Securities Class Action Clearinghouse* (available on the internet at http://securities.stanford.edu). The statistic of 366 issuer defendants speaks as of May 20, 1998. More current data are available at the Stanford Clearinghouse Internet site. *Id.*

[8] Denise N. Martin, Vinita M. Juneja, Todd S. Foster & Frederick C. Dunbar, *Recent Trends IV: What Explains Filings and Settlements in Shareholder Class Actions?* at ii (National Economic Research Associates 1996).

settled, allege violations of Section 10(b) and Rule 10b-5.[9] Hundreds of additional individual actions alleging violations of Section 10(b) and of Rule 10b-5 have also been filed in federal court in the last several years.[10] Section 10(b) and Rule 10b-5 are thus the "primary tool for private enforcement of the federal securities laws,"[11] and Congress,[12] this Court,[13] and the

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[9] Recent research indicates that at least 77% of these cases allege a violation of Section 10(b) and Rule 10b-5. *See* Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year's Experience* 23 (John M. Olin Program in Law & Economics, Stanford Law School, Working Paper No. 140, Feb. 1997) (noting that 23% of complaints analyzed alleged violations of the Securities Act of 1933). The percentage of complaints containing Rule 10b-5 allegations is undoubtedly higher than 77% because complaints that allege a violation of the 1933 Act also commonly allege violations of Rule 10b-5.

[10] According to the Administrative Office of the United States Courts, from June 1995 through June 1997, 5,348 cases involving "Securities, Commodities, and Exchanges" were filed in the federal courts. Administrative Office of the United States Courts, *Statistical Tables for the Federal Judiciary* Tbl. C-2 (Jun. 30, 1997); Administrative Office of the United States Courts, Statistical Tables for the Federal Judiciary Tbl. C-2 (Jun. 30, 1996). To be sure, there is an overlap between the securities class action filing data and the Administrative Office data, and not every case included in the Administrative Office data contains a Rule 10b-5 cause of action, but these data are nonetheless suggestive of the potential magnitude of federal litigation affected by the interpretation of Section 10(b) and Rule 10b-5.

[11] Thomas Lee Hazen, *The Law of Securities Regulation* § 13.2 (1996).

[12] *See, e.g.*, S. Rep. No. 104-98 (1995), *reprinted in* 1995 U.S.C.A.A.N. 679, 683 (noting that securities fraud actions "typically rest upon the so called 'catch-all' fraud provision in Section 10(b) of the 1934 Act and SEC Rule 10b-5").

[13] *See, e.g., Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 309 (1985).

Commission[14] have all emphasized the pivotal role that private securities fraud litigation plays in the proper functioning of our capital markets.

Section 10(b) and Rule 10b-5 are also central to the Securities and Exchange Commission's enforcement program. As the current Director of the Division of Enforcement recently emphasized, "Section 10(b) is the principal weapon used by the Securities and Exchange Commission to combat fraud in the securities markets."[15] The questions raised by the Third Circuit's decision go to the heart of the definition of the right of action under Section 10(b) and Rule 10b-5. They are, accordingly, central to the resolution of a large body of significant litigation currently pending before the court.

The issues raised in this litigation also have implications that reach far beyond the judicial process. Our nation's securities markets are in the midst of a rapid and profound technological change. "Alternative trading systems" are emerging in a variety of electronic forms, over the internet and elsewhere, and each of these trading systems has the potential to generate prices that differ at any point in time from those currently displayed on NASDAQ screens, or through the facilities of the New

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[14] *See, e.g., Private Litigation Under the Federal Securities Laws: Hearings Before the Senate Subcomm. on Securities, Comm. on Banking, Hous., and Urban Affairs,* 103d Cong., 1st Sess. 111 (statement of William R. McLucas, Director of the Division of Enforcement, SEC) (noting the important role that private securities litigation under the Rule 10b-5 plays in deterring securities law violations and compensating victims for fraudulent conduct).

[15] Richard Walker & David Levine, *The Limits of Central Bank's Textualist Approach – Attempts to Overdraw the Bank Prove Unsuccessful,* 26 Hofstra L. Rev. 1, 2 (1997).

York Stock Exchange.[16] The Third Circuit's holding suggests that it could be fraudulent for a broker-dealer to execute NASDAQ or NYSE trades without searching through these disparate alternative trading systems for prices that "maximize the plaintiffs' economic benefit." Pet. App. 16a. The imposition of such a duty threatens to destabilize market structures that have recently undergone extensive regulatory review, Pet. App. 27a, and in which substantial software and hardware investments have been and continue to be made.[17]

II. THE DECISION BELOW IS IN ERROR AND THREATENS TO EXPAND DRAMATICALLY THE SCOPE AND BURDEN OF SECURITIES FRAUD LITIGATION IN THE FEDERAL COURTS.

The decision below commits two major errors. Unless corrected, each has the potential to open the courthouse doors to federal securities law claims that were not contemplated by Congress and against which this Court has repeatedly warned.

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[16] *See generally* Regulation of Exchanges and Alternative Trading Systems, SEC Release No. 34-39884, 63 Fed. Reg. 29,301 (Apr. 29, 1998); Request for Comments, SEC Release No. 34-38672, 62 Fed. Reg. 30,485 (June 4, 1997).

[17] "Since 1994 NASDAQ has spent $160 million on technology development and enhancements." National Association of Securities Dealers, 1997 *Annual Report*, at 13. The NASDAQ market has also agreed to spend at least $300 million through the year 2003 to "provide capacity at a 2 billion share day level, scalable up to 8 billion shares." *Id.* at 45. The NASD also carries on its books data processing equipment and software with an undepreciated cost basis of $232.7 million. *Id.* at 47.

A. The Third Circuit Erred in Holding that an Alleged Breach of a Fiduciary Duty, Which Was Fully Disclosed to the Public and to Regulators, and Which Involved No Manipulation or Deception, Could Constitute Fraud Under Section 10(b).

In *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), this Court held that Section 10(b) and Rule 10b-5 can be violated only by conduct "involving manipulation or deception." *Id.* at 473. The Court therefore reversed a Second Circuit decision that had imposed Section 10(b) liability for "breaches of fiduciary duty by a majority against minority shareholders without any charge of misrepresentation or lack of disclosure." *Id.* at 470 (quoting 553 F.2d 1283, 1287 (2d Cir. 1976)). *Santa Fe* also expressly rejected the proposition that "neither misrepresentation nor nondisclosure was a necessary element of the Rule 10b-5 action." *Id.* It further cautioned that any attempt to "bring within the ambit of the Rule all breaches of fiduciary duty in connection with a securities transaction . . . would . . . 'add a gloss to the operative language of the statute quite different from its commonly accepted meaning.' " *Id.* at 472 (*quoting Hochfelder*, 425 U.S. at 199).

The Third Circuit's decision below committed the very error that this Court warned against in *Santa Fe*. The Third Circuit's decision also contains a dangerous twist that portends a potential explosion in the scope and volume of federal securities law litigation.

The Third Circuit asserted no misrepresentation or lack of disclosure with regard to the existence of a fiduciary obligation of best execution. Nor did the Third Circuit assert misrepresentation or lack of disclosure with regard to the industry's position that execution at NBBO

satisfied the fiduciary obligation of best execution.[18] The Third Circuit also concurred that the SEC was aware of the practice, as was the industry's self-regulatory organization. Pet. App. 26a. The practice was, moreover, described by the NASD in publicly available documents, and the press described the industry's practice and position.[19] The practice was, by all accounts, "no secret." Pet. App. 74a.

That should be the end of the matter here, because *Santa Fe* squarely holds that an ordinary breach of fiduciary duty, without any manipulation or deception, may be actionable under state law but does not violate Rule 10b-5. Put another way, where the defendant has not deceived the plaintiff either about the defendant's duty or about the defendant's actions, there is no fraud. Here, the defendants' duty was defined by the law, the defendants had informed the plaintiffs that they would execute trades in accordance with standard industry practices, and those practices were publicly disclosed to regulators and to the world. Whatever plaintiffs' complaints about the practice might be, they cannot claim to have been defrauded.

The Third Circuit, however, found a misrepresentation where *Santa Fe* holds that there can be none. The Third Circuit reasoned that:

> The alleged misrepresentation here is an implied representation made by the defendants when they agreed to execute plaintiffs' orders that they intended to maximize the plaintiffs' economic gain in the transaction . . . If the defendants intended not to act in a manner consistent with this expectation when they accepted the orders and yet did not so advise plaintiffs,

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[18] *See* text accompanying notes 4-5 *supra*.

[19] *See* text accompanying notes 4-6 *supra*.

> plaintiffs insist that the defendants can be found to have made an implied representation that they knew to be false.

Pet. App. 12a.

The error in this logic is glaring. By the Third Circuit's reasoning, any plaintiff can mutate a claim of fiduciary breach into one of fraud by simply asserting that the defendants never intended to honor their fiduciary obligations. Every claim of fiduciary breach in connection with the purchase or sale of securities can thereby be recast as a claim of securities fraud. But this is precisely the attempt to "bring within the ambit of the Rule all breaches of fiduciary duty in connection with a securities transaction" against which *Santa Fe* expressly warned. The Third Circuit's conclusion that defendants engaged in a misrepresentation therefore cannot be reconciled with *Santa Fe*, and constitutes clear error.

There was also no breach of fiduciary duty here. The Third Circuit was wrong to define defendants' duty as to "maximize the plaintiffs' economic gain." The duty is to execute trades at the "best *reasonably* available price," and that duty is not to maximize absolutely. Pet. App. 7a. Indeed, the imposition of a duty to "maximize" a customer's "economic gain" would effectively prevent a broker-dealer from earning any profit on a transaction because the intermediary's profit would reduce the customer's returns and would therefore be inconsistent with a duty to "maximize" the customer's gain. But without the opportunity to profit, the broker-dealer has no incentive to remain in business. The Third Circuit's locution of the best execution obligation is thus inconsistent with the very existence of a profit-motivated market populated by brokers, dealers, specialists, or other intermediaries subject to a fiduciary duty of best execution.

Indeed, the breadth of the Third Circuit's logic raises a natural question as to which there can be no satisfactory answer: What disclosure by defendants could have sufficed to prevent a finding of misrepresentation on these facts? The Third Circuit seems to require that, in order to avoid liability for fraud, defendants must accuse themselves of potentially breaching the duty of best execution by disclosing that they intended "not to act in a manner consistent" with that obligation. Pet. App. 12a. Defendants would have to make this disclosure notwithstanding the fact that they assert several objectively reasonable bases upon which to conclude that their conduct complied with the duty of best execution. Pet. App. 26a. Put another way, defendants would have to accuse themselves of a potential breach of fiduciary duty in order to avoid liability for fraud, despite the fact that they had a reasonable basis to believe they were in compliance with their fiduciary obligations.

This result creates an untenable "Catch 22" that Congress clearly never intended to write into the statute. *Santa Fe*, 430 U.S. at 474-77. It also violates the principle that the federal securities laws do not require persons to accuse themselves of breaches of fiduciary duty or "of antisocial or illegal activities," in order to avoid liability for fraud. *GAF Corp. v. Heyman*, 724 F.2d 727, 740 (2d Cir. 1983); *see also United States v. Matthews*, 787 F.2d 38 (2d Cir. 1986); James D. Cox, Robert W. Hillman & Donald C. Langevoort, *Securities Regulation: Cases and Materials* 102-03 (2d ed. 1997) ("The courts and the SEC rationalize the disclosure of basic facts and not characterizations or conclusions as providing all the information for investors to apply their expertise to make informed judgments . . . ").

B. The Third Circuit Erred in Holding that Publicly Disclosed Practices that Were Fully Known to Regulators Could Be Conducted With Scienter.

In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976), this Court held that negligence cannot suffice to establish a cause of action under Section 10(b). Plaintiffs must instead demonstrate that defendants acted with "scienter," which is defined as "a mental state embracing intent to deceive, manipulate, or defraud." *Id.* at 194 n.12. This Court has twice reserved the question of "whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) . . . " *Id.*; *Herman & MacLean v. Huddleston*, 459 U.S. 375, 378 n.4 (1983) (same). All Courts of Appeal that have addressed the issue have held that recklessness suffices to establish scienter under Section 10(b).[20]

The Securities and Exchange Commission explains that, "[t]he threshold for a finding of recklessness is quite high,"[21] and "requires a high level of culpability – a standard clearly distinguishable from negligence."[22] Indeed, the dominant definition of recklessness[23]

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[20] *See, e.g., Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 n.8 (9th Cir. 1990) (en banc), *cert. denied*, 499 U.S. 976 (1991) (collecting cases in support of the proposition that *Sunstrand* is the dominant standard); Brief of the United States Securities and Exchange Commission, Amicus Curiae, *In re Silicon Graphics Securities Litigation*, United States Court of Appeals for the Ninth Circuit, No. 97-16240, Nov. 1997, at 6 (available at http://securities.stanford.edu/briefs/sgi/9716240/sec.html).

[21] Brief of SEC, *supra* note 20, at 6.

[22] *Id.*

[23] *See, e.g., Hollinger*, 914 F.2d at 1569 & n.8 (collecting cases); SEC Brief, *supra* note 20, at 6; William H. Kuehnle, *On Scienter, Knowledge, and Recklessness Under the Federal Securities Laws*, 34 Houston L. Rev. 121, 180 (1997) ("The expression of

demands that an "omission must derive from something more egregious than even white heart/empty head good faith." *Sunstrand Chemical Corp. v. SunChemcial Corp.*, 553 F.2d 1033, 1045 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977). Therefore, "if a defendant genuinely forgot to disclose information or that it never came to mind" then there can be no finding of recklessness "even though the proverbial 'reasonable man' would never have forgotten." *Id.* at 1045 n.20; *see also id.* at 1047 ("an omission caused because [defendants] genuinely forgot about these facts would not be actionable, even if such an omission derived from inexcusable neglect") (citation omitted).

The Third Circuit, however, pointed to no evidence that could possibly support a finding of scienter, even if the definition of scienter is expanded to include recklessness. In particular, there is no evidence of a "high level of culpability," or of conduct "more egregious than white heart/empty head good faith," or even that defendants "generally forgot to disclose information." Indeed, if defendants had an evil or culpable intent, then:

- Why would they have disclosed their practices to the Securities and Exchange Commission?
- Why would they have disclosed their practices to the industry's self-regulatory organization?
- Why would they have described their practices in publicly available documents? and
- Why would they have disclosed sufficient information to allow the press to describe their activities in detail?

The Third Circuit had no answer to any of these questions, and we are aware of no instance in which any

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recklessness under section 10(b) that has come to be applied most commonly is the expression in *Sunstrand*.") (citations omitted).

court has found scienter in the face of comparable public disclosure and awareness on the part of regulators as to standard industry practice.

Bereft of any of the traditional bases for finding scienter, the Third Circuit cited a series of allegations by plaintiff that, even if accepted as true, would at worst support a finding of negligence. The Third Circuit found that some "respected members of the brokerage community recognized . . . that trades were available from sources other than the NBBO." Pet. App. 13a. It also found that "an SEC study found clear evidence of a two-tiered market during the class period." *Id.* It further found that the SEC ultimately adopted a regulation effectively requiring that the NBBO be expanded to include price quotations that were previously excluded from the system. *Id.*[24] But even so, allegations that defendants therefore did not "execute the plaintiffs' trade at the best *reasonably* available price," Pet. App. 7a (emphasis supplied) (defining duty of best execution), when pursuing a fully disclosed practice are, at worst, allegations of unreasonable conduct constituting negligence. They most certainly do not satisfy a threshold finding that is "quite high" or "clearly distinguishable from negligence." Nor do they connote culpability, or intent to deceive, manipulate, or defraud.

C. The Third Circuit's Errors Threaten to Expand the Scope and Burden of Securities Fraud Litigation in the Federal Courts Beyond Congressional Intent.

This Court has repeatedly recognized that Section 10(b) "does not by its terms create an express civil

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[24] The correct locution of the effect of the subsequently adopted SEC regulation is to be found in the panel decision at Pet. App. 27a.

remedy for its violation, and there is no indication that Congress, or the Commission when adopting Rule 10b-5, contemplated such a remedy. . . . " *Hochfelder*, 425 U.S. at 196; *see also Central Bank*, 511 U.S. at 173; *Musick, Peeler & Garret v. Employers Ins. of Wausau*, 508 U.S. 286, 295 (1993). This Court has also "made no pretense that it was Congress' design to provide the remedy afforded" by the implied private right of action under Section 10(b). *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 358 (1991).

In light of the implied nature of the private Section 10(b) remedy, this Court has repeatedly emphasized the need for "adherence to the statutory language." *Central Bank*, 511 U.S. at 173; *see also Santa Fe*, 430 U.S. at 472; *Hochfelder*, 425 U.S. at 197-201. Accordingly, when this Court adopted the scienter requirement for Section 10(b), it underscored the fact that the language of the statute "clearly connotes intentional misconduct." *Hochfelder*, 425 U.S. at 201. It also emphasized that any other reading "would add a gloss to the statute quite different from its commonly accepted meaning." *Id.* at 199. Similarly, when this court construed "fraud" under Section 10(b) as conduct distinct from a breach of fiduciary duty, it warned that "[t]he language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception." *Santa Fe*, 430 U.S. at 473.

The requirement that plaintiffs demonstrate intentional misconduct involving deception is therefore central to the definition of the Section 10(b) cause of action. The Third Circuit's decision below would, however, gut both these essential statutory requirements of any substance. It would allow every breach of fiduciary duty in connection with a securities transaction to be attacked as Section 10(b) fraud. It would also allow assertions of mere negligence in connection with a fully disclosed practice to

masquerade as intentional misconduct satisfying the requirement of scienter.

The net result of the Third Circuit's logic would be a dramatic expansion of the scope of Section 10(b) liability far beyond its already substantial reach, and far beyond any conceivable congressional intent. This expansion of liability would, moreover, promote "vexatious litigation" of the sort against which this Court has already warned, *Blue Chip*, 421 U.S. at 743, and would justify this Court's "concern that the inexorable broadening of the class of plaintiffs who may sue in this area of the law will ultimately result in more harm than good." *Id.* at 747-48.

CONCLUSION

For the reasons stated above, the Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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